U. S. DEPARTMENT OF AGRICULTURE
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FOREST SERVICE
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FEDERAL INCOME TAX TIPS FOR THE SMALL TIMBER OWNER

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Many small timber owners pay a larger Federal income tax on their woods operations than the law requires. This results in part from failure to deduct an allowance for depletion representing the owner's investment in the timber harvested. Also, many owners do not realize that receipts from sales of timber and forest products can frequently be reported as a capital gain rather than as ordinary income, and that this can substantially reduce their tax.

The examples that follow cover typical income tax situations of small forest-land owners. The explanations may help the timber owner to save money and to simplify the preparation of his tax return.

Consideration is given to treatment of receipts from sales of timber and forest products, and, more briefly, to losses of timber from fire or other casualty and to costs of forest ownership and operation. No attempt is made to cover all aspects of the subject, and the explanations given should not be considered binding upon the Internal Revenue Service. A more complete discussion is given in Agriculture Handbook No. 52, "The small timber owner and his Federal income tax" which is for sale by the Superintendent of Documents, Washington 25, D. C., at 20 cents a copy.

Receipts From Sales of Timber and Forest Products

1. Treating receipts as ordinary income

If receipts were so small that you wish to use a shortcut method of reporting them even though this may cost you a few dollars more in taxes, use the ordinary income method shown in Example 1, following. At 1954 tax rates the additional cost for most taxpayers is likely to be less than $10 on a $100 timber sale and less than $5 on a $50 timber sale.

a. Farmers on the cash basis of accounting should report receipts on the farm schedule, Form 1040F, page 1, item 3, "Other farm income" under "Wood and lumber" or "Other forest products."

b. Non-farmers will usually report receipts directly on the income tax return itself, Form 1040, page 2, under Schedule G, "Income from other sources."

c. A reasonable allowance for depletion of the capital investment in the timber may be claimed. Farmers should include such an allowance on Form 1040F, page 2, "Farm expenses for taxable year" under "Other farm expenses (specify)." Non-farmers will usually deduct the depletion allowance from receipts and enter the net figure on Form 1040, page 2, under Schedule G. In either case a short explanation should be attached, as in the following example.

<u>Example 1</u>. Treating receipts from sales of timber and forest products as ordinary income

Brown is a farmer using the cash basis of accounting. He bought his farm in 1949 for $6,700 and estimates that a reasonable split of the purchase price among land, buildings, and timber would have been as follows:

Land	$4,000
Buildings and other improvements	1,200
Timber (excluding land)	1,500
	$6,700

In 1954 Brown cut one-tenth of his timber, sawed it into lumber, and sold it for $400. His sale would be treated as follows:

On Form 1040F, page 1, item 3, opposite "Wood and lumber" enter	$400
On Form 1040F, page 2, under "Farm expenses for taxable year--other farm expenses" enter "Timber depletion"	150

Also enter "Explanation: Capital investment in timber, $1,500. Cut this year, one-tenth. Depletion claimed, 1/10 or $150."

Brown incurred expenses for labor, materials, etc., in connection with timber operations for the year and should also enter these on Form 1040F. See the explanation on page 7 under "Costs of forest ownership and operation."

2. Treating receipts as capital gain

If receipts from sales of timber or forest products during the year were substantial, it will usually be to your advantage to use the capital gains method to the extent permitted by law.[1] The reporting of receipts by the capital gains method varies to some extent, depending upon the type of timber sale. Ask yourself which of the following three situations applies to you.

a. Standing timber sold on a lump-sum basis. A lump-sum sale is one in which you sell stumpage outright and are paid a fixed amount agreed upon in advance. The sale may cover all the timber standing on a given acreage or tract of land, or it may cover certain species, diameter classes, or marked timber only.

b. Standing timber sold on a pay-as-cut basis. A pay-as-cut sale is one in which you sell stumpage for a stated price per thousand board feet, cord, or other physical unit. You retain ownership until the trees are cut by the purchaser and your receipts depend upon the volume realized.

c. Timber cut by the taxpayer, who sells the resulting products, such as sawlogs, lumber, pulpwood, fuelwood, cross ties, etc.

The treatment of each of these three types of sale is described separately on page 3-6. Before turning to the section that applies to you, however, it is well to find your depletion allowance, which is not affected by the type of sale. Exactly the same principles apply as were illustrated in Example 1 under the ordinary income method, but a more complete explanation is given here because the amounts involved may be larger.

Depletion Allowance

To find your allowance for depletion, simply divide the dollar amount of your capital investment in the timber at time of harvest by the physical volume of timber present in the

[1] Proceeds from sales of standing timber held primarily for sale to customers in the ordinary course of business must be reported as ordinary income. This is regarded as applying to timberland dealers and not to timber owners making occasional sales. Proceeds from sales of Christmas trees are entitled to capital gains treatment if such trees are more than 6 years old when severed from the roots.

stand. This gives the depletion per unit of volume. Then multiply the unit depletion by the number of units sold or cut, and you have your depletion allowance.

This is essentially what Brown did in Example 1. His investment in the timber was $1,500. Its physical volume was 300,000 board feet. $\frac{\$1,500}{300,000 \text{ bd. ft.}} = \$5$ per thousand feet, which is the unit depletion. Brown cut one-tenth of the timber, or 30,000 board feet. His depletion allowance is then 30,000 board feet X $5 per thousand feet = $150 as in Example 1.

Your calculation may not be as simple as Brown's, since your timber investment may have changed over the years because of timber sales, additional timber purchases, or expenditures that you have capitalized, such as those for tree planting (capital expenditures are discussed on page 7 under "Costs of forest ownership and operation"). Moreover, the physical volume of timber may have changed because of previous sales, purchases, fire losses, timber growth, etc. Any such adjustments in your timber investment or timber volume must naturally be reflected in the calculation of the depletion allowance.

Example 2. Calculating the depletion allowance

Black bought a farm in 1940 for $10,000 and estimated that $1,400 of the purchase price should be allocated to timber (excluding value of land). In 1944 planting costs of $100 were incurred. In 1950 he bought a second tract having a timber value of $2,000 at time of purchase, making a total investment in timber of $3,500. The volume of timber on the first tract at time of purchase was 300,000 board feet, that on the second tract 200,000 board feet. Growth on the first tract at the close of 1952 was estimated to be 90,000 board feet. In 1954 Black sold 60,000 board feet. What was his depletion allowance?

Timber investment		Timber volume	
First tract	$1,400	First tract	300,000 board feet
Planting costs	100	Second tract	200,000 " "
Second tract	2,000	Growth	90,000 " "
Total	$3,500	Total	590,000 " "

Unit depletion $\frac{\$3,500}{590,000 \text{ bd. ft.}} = \$5.93$ per thousand board feet. Depletion allowance, 60,000 bd. ft. sold X $5.93 per thousand board feet = $355.80.

For use in calculating his depletion allowance in the future, Black will carry forward a timber investment of $3,144.20 ($3,500.00 less $355.80) and a timber volume of 530,000 board feet (590,000 board feet less 60,000 board feet).

Three Types of Sale

In reporting receipts as a capital gain, use Federal income tax Schedule D,[2] "Gains and losses from sales or exchanges of property." The way this Schedule is used depends upon which of the three types of timber sale was made. These are taken up in turn. In the illustrations it is assumed in each case that Black, the taxpayer in Example 2, made a sale involving 60,000 board feet of timber and that his depletion allowance amounts to $355.80.

a. Standing timber sold on a lump-sum basis

If you had owned the timber 6 months or less at date of sale, enter the transaction on Schedule D under "Capital assets--short-term capital gains and losses--assets held not more than 6 months."

[2] Schedule D is reproduced on page 8.

If you had owned the timber more than 6 months at date of sale, enter the transaction on Schedule D under "Long-term capital gains and losses--assets held for more than 6 months." In either case the eight columns on Schedule D may be filled in, using the following example as a guide.

Example 3. Treating receipts as capital gain--lump-sum timber sale

Black, the taxpayer in Example 2, sold 60,000 board feet of timber on August 15, 1954, for a lump sum of $900. What entries does he make on Schedule D?

Because Black owned the timber more than 6 months, he treats it as a long-term capital asset and enters the data on line 7 of Schedule D. He makes entries as follows:

Col.	a. Kind of property	60,000 bd. ft. pine stumpage; lump-sum sale.
"	b. Date acquired	2-20-40.
"	c. Date sold....................	8-15-54.
"	d. Gross sales price	$900.
"	e. Depreciation	(Leave blank.)
"	f. Cost or other basis (depletion allowance).	$355.80 (attach explanation as in Example 2).
"	g. Expense of sale.............	$50 (timber cruise).
"	h. Gain or loss (col. d less sum of cols. f and g).	$494.20.

The capital gain of $494.20 from sale of timber, together with any other capital gains or losses listed on Schedule D, is then carried forward as indicated on the schedule, and the net taxable gain or loss is transferred to the tax return (Form 1040).

b. Standing timber sold on a pay-as-cut basis

If you had owned the timber 6 months or less, you cannot use the capital gains method but must treat the gain as ordinary income as in Example 1.

If you had owned the timber 6 months or more, you group the gain from sale of timber with certain other gains and losses as listed below. If total gains exceed total losses, each gain and each loss is entered on Schedule D as a long-term capital gain or loss. On the other hand, if total gains do not exceed total losses, then each gain and each loss is entered at the top of Schedule D under "Property other than capital assets."

The kinds of gains and losses that must be grouped together are those arising from--

1. The sale or exchange of land or depreciable property used in your business and held more than 6 months, for example, farm land, trucks, or tractors.

2. The sale or exchange under certain conditions of unharvested crops and of livestock held for draft, breeding, or dairy purposes.

3. Damage by fire or other casualty, or condemnation of the types of property listed under 1 and 2 or of capital assets including standing timber held more than 6 months.

4. Sale on pay-as-cut basis of timber held more than 6 months, or cutting of timber held more than 6 months.

Example 4. Treating receipts as capital gain--pay-as-cut timber sale

Black, the taxpayer in Example 2, signed a timber-sale contract on August 15, 1954, calling for payment at the rate of $18 per thousand board feet (Scribner log rule). 60,000 board feet was cut and Black was paid $1,080. What entries does he make on Schedule D?

Because Black owned the timber more than 6 months, he can use the capital gains method.

Gross sales price..		$1,080.00
Less: cost (depletion allowance)....	$355.80	
expense of sale (cruise, including marking and scaling)....................	100.00	
		455.80
Capital gain....................................		$ 624.20

Black next groups his gains and losses as follows:

	Gain	Loss
Gain on pay-as-cut sale of timber ...	$624.20	
Gain on sale of tractor	75.00	
Gain on sale of farmland	500.00	
Loss on sale of livestock		$400.00
Loss of timber by forest fire.........................		50.00
	$1,199.20	$450.00

Since the gains exceed the losses, each item is listed individually on Schedule D as a long-term capital gain or loss. Black enters his gain from sale of timber in columns a-h inclusive, as in Example 3.

If gains had not exceeded losses when grouped as above (for example, if the loss on livestock amounted to $1,500, thus making total losses $1,550), then each item would have to be listed individually at the top of Schedule D under "Property other than capital assets." Black would make the same entries in columns a-h inclusive as before, but would place them on line 1 at the top of Schedule D instead of on line 7.

c. Timber cut by taxpayer and resulting products sold

If you had held the timber 6 months or less on the first day of the taxable year in which it was cut, you cannot use the capital gains method but must treat the gain as ordinary income as in Example 1.

If you had held the timber more than 6 months on the first day of the taxable year and intended it for sale or for use in your business, you can, if you wish, report your total gain in two parts.

1. The difference between your investment in the standing timber (the depletion allowance) and its fair market value as of the first day of the taxable year in which it was cut. This can be treated as a capital gain.

2. The difference between the fair market value of the standing timber and the proceeds from sales of resulting products (less processing costs). This must be treated as ordinary income.

Although the law does not require you to report the cutting of timber in this way, it is usually to your advantage to do so. Once this method has been elected, it must be continued unless permission is obtained from the Internal Revenue Service to discontinue it.

In reporting your gain in two parts as just described, you first need to find the fair market value, as of the first day of the taxable year, of the standing timber that was cut. For this purpose you can usually use the local "going" price per thousand board feet, cord, or other unit of stumpage in your area of the species and quality sold. Adjustments should be made if necessary to reflect the condition of your own timber. Your local extension, farm, or service forester will probably be able to furnish a fair market value for stumpage in your area upon request. If you wish, you may consult a private practicing forester.

When you have established the fair market value of the timber cut, the capital gain under paragraph 1 above is entered on Schedule D just as in Example 4 and the ordinary income under paragraph 2 above is entered as explained in Example 1. The transaction as a whole is illustrated in the example that follows.

Example 5. Timber cut by taxpayer and resulting products sold

Black, the taxpayer in Example 2, cut 60,000 board feet of timber during the year 1954 and sold the resulting sawlogs at roadside for $1,800. The fair market value on January 1, 1954, of the timber cut was estimated to be $1,080. Black's depletion allowance is $355.80 as in Example 2. His logging and skidding costs amounted to $435. What entries does Black make?

1. The difference between Black's investment in the standing timber and its fair market value as of the first day of the taxable year in which it was cut.

Fair market value of timber cut	$1,080.00
Less: depletion allowance	355.80
Capital gain	$ 724.20

This gain is grouped with other gains and losses of the four kinds listed on page 4, and entered on Schedule D accordingly.

2. The difference between the fair market value of the standing timber and the proceeds from sales of resulting products.

Proceeds from sale of sawlogs		$1,800.00
Less: fair market value of		
standing timber	$1,080.00	
logging and skidding costs	435.00	
		1,515.00
Ordinary income		$ 285.00

This income is entered on Form 1040F as in Example 1.

Losses of Timber From Fire, Windstorm, or Other Casualty

If your timber was damaged during the year, you may be entitled to claim a deduction on your income tax return. It is important to remember, however, that your loss for tax purposes is not the difference between the value of the timber before the casualty and its value after the casualty. Your deduction is limited to the difference between your investment in the timber damaged and its value after the casualty, as increased by any insurance or other recoveries. For an explanation of the way losses are reported, see Agriculture Handbook No. 52, mentioned on page 1.

Costs of Forest Ownership and Operation

Operating expenses may be "expensed," that is, deducted from gross income year by year. These expenses may include the cost of hired labor, hire of animals, trucks, tractors, or other equipment, purchase of tools of short life or small cost such as axes, saws, sledges, wedges, etc., cost of materials and supplies, incidental repairs, machine operating expenses, and also management costs such as fees charged by consulting forester, accountant, etc. Operating expenses should be listed on the farm schedule, Form 1040F, page 2, under "Farm expenses for taxable year."

Capital expenditures, unlike operating expenses, are "capitalized," that is, treated as an investment to be recovered through depletion in the case of timber or through depreciation in the case of equipment. Purchase of standing timber and of equipment having a useful life of more than 1 year, and expenditures for seeding or planting or for major equipment repairs must all be capitalized (see Example 2, in which planting costs of $100 were capitalized).

In the case of timberlands that are not producing income you may either expense or capitalize your carrying charges and development expenditures; however, you must follow a consistent policy from year to year. Carrying charges include annual taxes, interest payments, protection costs such as for fire or pest control, and insurance premiums. Development expenditures include costs of girdling, poisoning, pruning, and improvement cuttings but should be reduced by incidental amounts received for products sold. It will usually be to your advantage to expense rather than capitalize costs if you have a choice.

In the case of timberlands that are producing income, costs such as those described in the paragraph above are regarded as operating expenses and must be expensed. For fuller treatment of costs of forest ownership and operation, see Agriculture Handbook No. 52.

QUESTIONS AND ANSWERS

1. Is income from forest land taxed at the same rate as income from farm land?

While the tax rate itself does not differ with the source of income, forest-land income may in effect be taxed at a lower rate than certain types of farm income, because of the capital gains provisions applying to timber sales.

2. Is timber growth taxable?

Timber growth is not taxable as such. Increase in value of standing timber, whether due to growth or to market appreciation, is taxable when the timber is sold or, in certain cases, when it is cut, but is not subject to income tax until that time.

3. How should standing timber (stumpage) value be separated from returns due to labor in arriving at fair value of stumpage?

The stumpage value should represent the price at which timber of comparable quality and location is currently selling as it stands uncut in the woods. The local district forester will usually be in a position to estimate the unit selling price for comparable timber.

4. Is it necessary to wait until timber harvest before deducting any or all expenses?

No. Costs that are expensed may be deducted year by year from gross income. Costs that are capitalized, on the other hand, cannot be recovered until timber harvest.

5. Is a taxpayer permitted to deduct as an expense the value of his own labor?

No.

SCHEDULE D
For use with Forms 1040, 1041, and 1065

U. S. Treasury Department—Internal Revenue Service

GAINS AND LOSSES FROM SALES OR EXCHANGES OF PROPERTY

USE WITH INDIVIDUAL, FIDUCIARY, OR PARTNERSHIP RETURNS

1954

For Calendar Year 1954, or other taxable year beginning ______, 1954, and ending ______, 195

Name and Address

Check type of return filed: ☐ Form 1040 ☐ Form 1041 ☐ Form 1065

(I) PROPERTY OTHER THAN CAPITAL ASSETS

a. Kind of property (if necessary, attach statement of descriptive details not shown below)	b. Date acquired (mo., day, yr.)	c. Date sold (mo., day, yr.)	d. Gross sales price (contract price)	e. Depreciation allowed (or allowable) since acquisition or March 1, 1913 (attach schedule)	f. Cost or other basis and cost of subsequent improvements (if not purchased, attach explanation)	g. Expense of sale	h. Gain or loss (column d plus column e less sum of columns f and g)
1.			$	$	$	$	$

2. Net gain (or loss). Enter here and on line 1, Schedule D, Form 1040, or as item 8 (a), page 1, Form 1041, or as item 11, page 1, Form 1065 .... $

(II) CAPITAL ASSETS

Short-Term Capital Gains and Losses—Assets Held Not More Than 6 Months

3.			$	$	$	$	$

4. Enter your share of net short-term gain (or loss) from partnerships and fiduciaries ....
5. Enter unused capital loss carryover from 5 preceding taxable years (**Attach statement**) ....
6. Net short-term gain (or loss) from lines 3, 4, and 5. Enter here and in Schedule D, Form 1041, or as item 26, page 1, Form 1065 .... $

Long-Term Capital Gains and Losses—Assets Held More Than 6 Months

7.			$	$	$	$	$

8. Enter the full amount of your share of net long-term gain (or loss) from partnerships and fiduciaries ....
9. Net long-term gain (or loss) from lines 7 and 8. Enter here and in Schedule D, Form 1041, or as item 27, page 1, Form 1065 .... $

● **LINES 10 THROUGH 25 NOT APPLICABLE TO FIDUCIARIES AND PARTNERSHIPS**

Gain or Loss To Be Taken Into Account	a. Gain	b. Loss
10. Enter net short-term gain (or loss) from line 6	$	$
11. Enter net long-term gain (or loss) from line 9	$	$
Use lines 12 through 15 only if gains exceed losses in lines 10 and 11.		
12. Enter short-term gain (line 10, col. a) reduced by any long-term loss (line 11, col. b)	$	
13. Enter long-term gain (line 11, col. a) reduced by any short-term loss (line 10, col. b)	$	
14. Enter 50 percent of line 13	$	
15. Enter here and on line 2, Schedule D, Form 1040, the sum of lines 12 and 14	$	
Use lines 16 and 17 only if losses exceed gains in lines 10 and 11.		
16. Enter the excess of losses over gains on lines 10 and 11		$
17. Enter here and on line 2, Schedule D, Form 1040, the **smallest** of the following: (a) the amount on line 16; (b) taxable income computed without regard to capital gains and losses and the deduction for exemptions; or (c) $1,000 ..		$

COMPUTATION OF ALTERNATIVE TAX FOR INDIVIDUALS (Form 1040)

(See instructions on other side as to when the alternative tax applies)

18. Enter from page 3, Form 1040, the income from line 5 if separate return or line 7 (a) if joint return .... $
19. Enter amount from line 14, column a, above, if separate return, or half of such amount if joint return ....
20. Balance (line 18 less line 19) .... $
21. Enter tax on amount on line 20 (Use applicable Tax Rate Schedule in Form 1040 Instructions) .... $
22. If joint return, multiply amount on line 21 by two .... $
23. Enter 50 percent of line 19 .... $
24. If joint return, multiply amount on line 23 by two .... $
25. Alternative tax (line 21 plus line 23 if separate return; line 22 plus line 24 if joint return). If smaller than amount on line 6 or line 7(c), page 3, Form 1040, enter this alternative tax on line 8, page 3, Form 1040 .... $

NOTE.—In lines 18 to 25 the treatment in the case of a joint return is also applicable to a return of a surviving widow or widower.

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